DEVELOPMENTS IN THE CHANGE OF ECONOMIC CIRCUMSTANCES DEBATE?

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CONTENTS

1 INTRODUCTION

Businessmen and jurists involved in international commercial transactions are well aware that unforeseen events affecting the performance of a party often arise. The probability that such unpredicted events will arise is much higher than in the case of internal contracts, where both parties are subject to the same domestic legal and economic environment. [1] Indeed, international commercial transactions involve additional risks such as economic, political and natural risks.

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1 Brunner, C., *Force majeure and hardship under general contract principles*, 2009, Kluwer Law International, The Hague, at p. 75.

With reference only to changes of economic circumstances, the purpose of the present paper is to discuss the treatment of such events (only those which make performance *excessively* onerous) under Art. 79 of the *United Nations Convention on Contract for the International Sale of Goods* (**CISG** or **Convention**).[2] In particular, it will be investigated whether unforeseen supervening changes of economic circumstances can fundamentally alter the equilibrium of the contract and, therefore, be considered an impediment beyond the parties' control according to Art. 79 CISG.

Those changes are unlikely to arise with short-term contracts, which often exhibit a simple structure. In international trade, however, many contracts are of a more complicated structure and they are usually relatively long-term ones. Those contracts are the object of the present analysis. In this direction, it is noteworthy to underline that events such as the breakdown of economic systems or other economic downturns can considerably change the equilibrium of the contract under which the parties had calculated their risks, costs and benefits. Therefore, it will be discussed whether the use of a threshold test, i.e. the determination of a percentage of the cost or the value of the performance likely to amount to a fundamental alteration of the equilibrium of the contracts, fulfills the needs of the international transactions world.[3]

In the pursuit of the aforementioned goals, the provisions of the *UNIDROIT Principles of International Commercial Contracts* (**UPICC**)[4] and the *Principles of European Contract Law* (**PECL**)[5] will be also analyzed in order to verify whether the hardship provisions of the UPICC and PECL can be invoked to expand the meaning of impediment found in the CISG to include cases of economic or commercial hardship.

2 *A GLIMPSE OF THE HISTORY OF ARTICLE 79*

Article 79 CISG is the principal provision governing the extent to which a party is exempt from liability for a failure to perform any of his obligations due to an impediment beyond his control. Article 79 CISG, however, does not terminate the contract, but it rather provides a shield against liability. More specifically, under CISG Arts. 45(1)(b) and 61(1)(b), a party has a right to claim damages for the other party's non-performance without the necessity of proving fault, lack of good faith or the breach of an express promise.[6]

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2 United Nations Convention on Contracts for the International Sale of Goods (**CISG**), Vienna (1980).

3 *See* Schlechtriem, P., *Uniform Sales Law - The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, also available at: <http://www.cisg.law.pace.edu/cisg/biblio/schlechtriem.html>.

4 UNIDROIT Principles of International Commercial Contracts (**UPICC**) (2004).

5 Principles of European Contract Law (**PECL**) (1999).

6 Under the CISG, the parties guarantee that the contract will be performed in accordance with their promises; the promisor, therefore, is liable for any objective failure to perform his obligation, regardless of the reasons for the failure. *See* Stoll, H, "Exemptions" in Schlechtriem, P. (ed), *Commentary on the U.N. Convention on the International Sale of Goods* (CISG), Geoffrey Thomas trans., 2d ed., 1998, 600, para. 6, at p. 603.

The question whether economic difficulties represent a situation of hardship or can amount to an impediment was one of the controversial points in the preliminary *United Nation Commission on International Trade Law* (**UNCITRAL**) discussions.[7] The controversy was partly caused by the change in terminology from 'circumstances' in Art. 74(1) of *Uniform Law for the International Sale of Goods* (**ULIS**) to 'impediments' in Article 79 CISG.[8]

Indeed, Art. 79 CISG is a revised version of Art. 74 ULIS. The latter based the exemption from liability for non-performance on the occurrence of circumstances that, according to the intention of the parties at the time of the conclusion of the contract [the non-performing party], was not bound to take into account or to avoid or to overcome.[9] Article 74 ULIS was heavily criticised since it was thought to unjustifiably facilitate the promisor's excuse for non-performance. The UNCITRAL Working Group's introduction of the notion of impediment in the revised exemption provision was, therefore, intended to ensure a narrow and objective interpretation of Art. 79 CISG.

In other words, this change responded to concerns that the reference to 'circumstances' could be a basis for excuse merely because performance became more difficult or unprofitable. Taking into consideration that Art. 79 CISG seems to deal with the issue of changed circumstances on an international level by avoiding any reference to existing domestic concepts, the present article will try to answer this issue without directly referring to domestic legal systems. In fact, these systems differ greatly from each other in regard to rules of hardship; such discrepancy would produce divergent results in the interpretation and application of the CISG and would also contravene the uniformity mandate of Art. 7(1) CISG. Indeed, Art. 79 CISG was intended to define the boundaries of the obligor's performance obligation in an exhaustive manner.[10]

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7 *See* Honnold, J. O., "UN Convention on Contracts for the International Sale of Goods 1980" (1981) 15 *J. World Tr. L.* at pp. 265-267.

8 UNIDROIT, Uniform Law on the International Sale of Goods (**ULIS**) (1964).

9 Flambouras, D. P., "The Doctrines of Impossibility of Performance and clausula rebus sic stantibus in the 1980 Vienna Convention on Contracts for the International Sale of Goods and the Principles of European Contract Law: A Comparative Analysis" (Fall 2001), 13 *Pace International Law Review* 261.

10 Rimke, J., *Force majeure and hardship: Application in international trade practice with specific regard to the CISG and the UNIDROIT Principles of International Commercial Contracts*, *Pace Review of the Convention on Contracts for the International Sale of Goods*, 1999-2000, Kluwer Law International, The Hague, at pp. 197-243; also available at: <http://www.cisg.law.pace.edu/cisg/biblio/rimke.html>.

3 DOCTRINE OF REBUS SIC STANTIBUS AS AN EXCEPTION OF THE GENERAL PRINCIPLE OF PACTA SUNT SERVANDA

Changes in economic circumstances or the tightening of credit markets cannot generally constitute an event of force majeure, even in an extreme economic downturn like the one that the world is facing right now.[11]

As mentioned above, unforeseen supervening changes of economic circumstances can distort the balance of performance and counter-performance, as well as their respective values, and therefore they can fundamentally alter the equilibrium of the contract. The present paper considers which party should bear the risk of such a change of circumstances and to what extent. Such an analysis cannot be adequately conducted without weighing the fundamental principle of *pacta sunt servanda* against the doctrine of *rebus sic stantibus*. On the one hand, the principle of *pacta sunt servanda* (or the "sanctity of contract") suggests that the parties remain bound to the terms of their agreement as long as performance of their obligations is still physically possible. On the other hand, performance obligations are subject to the principle of good faith and the related doctrine of *rebus sic stantibus*.[12] As a matter of principle, parties must adhere to the terms of their contract.[13] *Pacta sunt servanda* is indeed a paramount principle in all legal systems:[14] the ones which are based on Roman law and other European civil codes, and the ones which are based on Anglo-Saxon Common Law and Islamic Jurisprudence 'Shari'a'.[15] It reflects natural justice and

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11 *See*, among the others, an interesting decision issued by Mr. Justice Hamblen, Queen's Bench Division, Commercial Court (England, 19 January 2010) *Tandrin Aviation Holdings Ltd v. Aero Toy Store LLC and another* [2010] EWHC 40 (Comm); Tandrin agreed to sell to ATS an aircraft for US $31.75 million, payable by an initial deposit of US $3 million into an escrow account, with the balance due on delivery. The contract contained a force majeure clause. ATS refused to accept delivery, and Tandrin exercised its contractual right to terminate the contract and sought to obtain the US $3 million deposit which under the contract was payable to Tandrin by way of liquidated damages in the event of failure to accept the aircraft. ATS refused to allow the deposit to be released. Hamblen J held that there was no triable issue that the liquidated damages clause was a penalty, in that the sum was relatively small and not extravagant or unconscionable, that the clause was in standard use and that it was limited to refusal to accept delivery. Tandrin could not rely on the force majeure clause simply by arguing that there had been a cataclysmic pitfall in the world's financial markets, as a change in economic circumstances was not recognised by English law as giving rise to force majeure. An order for specific performance was appropriate.

12 *See* Brunner, C., *supra* fn 1 at p. 391. As a general concept, the idea of adapting agreements and promises to an unforeseeable and extraordinary change has its roots in roman philosophy with Cicero and Seneca.

13 *See* van Houtte, H., "Changed Circumstances and Pacta Sunt Servanda" in Gaillard ed., *Transnational Rules in International Commercial Arbitration*, ICC Publ. Nr. 480,4, Paris (1993); p. 107; available at: <http://tldb.uni-koeln.de/TLDB.html>; TLDB Document ID: 117300.

14 *Ibid.* at p. 108.

15 *See* Liu, C., *Changed Contract Circumstances*, available at: <http://www.cisg.law.pace.edu/cisg/biblio/liu5.html#cl1>.

economic requirements because it binds a person to its promises and protects the interests of the promisee.[16]

The rule *pacta sunt servanda* is the basis of every contractual relationship and is still the heart of the matter in modern times for reasons of legal certainty and stability.[17] No doubt international arbitrators apply *pacta sunt servanda* either as a transnational principle of private law" or as "a cornerstone of the *lex mercatoria*.[18]

However, keeping in mind that *pacta sunt servanda* is a general principle of law, one should also note that "practice has demonstrated that on many occasions this principle may lead to the opposite of its aim".[19] It is arguable that the promisor should not be held to his promise when circumstances have changed so fundamentally that a hardship or force majeure event has occurred to him. The main issue here is the choice to be made between the strict application of *pacta sunt servanda* and the possible application of the *clausula rebus sic stantibus* (i.e. the contract remains binding provided that things remain as they are).[20]

That is to say, the situation existing at the conclusion of the contract may subsequently have changed so completely that the parties, acting as reasonable persons, would not have made the contract, or would have made it differently, had they known what was going to happen.[21]

Different legal concepts deal with the issue of changed circumstances and provide for the discharge of the duty to perform of one or both parties when a contract has become unexpectedly onerous or impossible to perform. The classic concept of *force majeure* is primarily directed at settling the problems resulting from non-

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16 *See* Maskow, D., "Hardship and Force Majeure" (1992) 40 *American Journal of Comparative Law*. at pp. 657-669. .

17 *See* Puelinckx, A.H., "Frustration, Hardship, Force Majeure, Imprévision, Wegfall der Geschäftsgrundlage, Unmöglichkeit, Changed Circumstances" (1986) 3 Journal of International Arbitration No. 2 at p. 47; available at: <http://tldb.uni-koeln.de/TLDB.html>; TLDB Document ID: 128100.

18 See van Houtte, H., Paris, *supra*. fn 13, at p. 109. *See also* Goldman, B., "The Applicable Law: General Principles of Law - The Lex Mercatoria" in Lew (ed.), *Contemporary Problems in International Arbitration,* London (1986), at p. 125; available at: <http://tldb.uni-koeln.de/TLDB.html>; TLDB Document ID: 112400, who notes that this principle is embodied in practically all municipal legislations (however, not without "differences as to its strength, and consequently as to its effects). Nevertheless, it is to be noted, that very frequently, when applying *pacta sunt servanda*, arbitrators do not refer to a particular municipal legislation; they see the principle as a general one, which means that it is applied as an element of the *lex mercatoria*, and therefore, that its actual consequences are not to be taken from any municipal law whatsoever.

19 *See* Maskow, D., *supra* fn 16, at 663.

20 *See* Goldman, B., *supra* fn18.

21 *See* Rimke, J., *Force majeure and hardship: Application in international trade practice with specific regard to the CISG and the UNIDROIT Principles of International Commercial Contracts, Pace Review of the Convention on Contracts for the International Sale of Goods*, 1999-2000, Kluwer, 197-243, and also Schmitthoff, C.M., *Schmitthoff's Export Trade* 146 (8 ed. 1986), C. Schmitthoff ed.

performance, either by suspension or by termination. Concepts like hardship are mainly directed at the adaptation of the contract.[22]

Although many legal systems take notice of the situation of changed circumstances, the conditions under which they allow the defense of *force majeure* vary. Furthermore, the adaptation of the contract is not universally accepted. Attempts have been made to tackle these problems on an international level. These attempts, however, are generally not regarded as being able to solve the problem entirely. Parties to international sales transactions, therefore, frequently include special clauses in their contracts dealing with matters of hardship and *force majeure*.

As it will be analysed below, whatever the significance of *pacta sunt servanda* in legal theory, its weight may be tempered by the principle of *rebus sic stantibus*. This is evidenced by the fact that arbitral tribunals in practice and various international organisations through codifications have admitted the doctrine of *rebus sic stantibus*, even though only in exceptional cases. Accordingly the principle of *rebus sic stantibus* is universally considered as one of strict and narrow interpretation. Indeed, regardless of the significance given to the concept of changed circumstances (as an excuse for non-performance or just as a ground for the adaption of the contract), it is necessary to limit the application of the doctrine of *rebus sic stantibus* to cases where compelling reasons justify it, having regard not only to the fundamental character of the changes, but also to the particular type of the contract involved, to the requirements of fairness and equity and to all circumstances of the case. [23] Nonetheless *rebus sic stantibus* is also a principle of international treaty law,[24] even though Art. 62 of the *1969 Vienna Convention on the Law of Treaties* (**Vienna Convention**) demonstrates the exceptional character of *rebus sic stantibus*[25] which is subordinate to the more general principle of *pacta sunt servanda*, as set out in Art. 26 of the Vienna Convention.[26]

Even though the Vienna Convention is a treaty concerning the customary international law on treaties between states, it is nonetheless possible to draw some interesting principles applicable to the doctrine of *rebus sic stantibus*. Certainly, the change in circumstance has to be fundamental and unforeseeable: it has to jeopardise the survival of the State. Having pointed out that, the two major legal concepts dealing with the problem of changed circumstances are those of *force majeure* and hardship. In order to give a reasonable interpretation of Article 79 CISG and of the

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22 *Ibid.*, at p. 197.

23 *See* ICC Award No. 1512 (1971), Yb. Comm. Arb., 1976, at pp. 128-129.

24 *See* Haraszti, G., *Treaties and Fundamental Change of Circumstances*, R.C.A.H., 1975 III, 7.

25 Art. 62 of the Vienna Convention on the Law of Treaties reads: "*A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless: (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and (b) the effect of the change is radically to transform the extent of the obligations still to be performed under the treaty*".

26 *See* van Houtte, H., *supra* fn 13 at p. 105.

principles on *force majeure* and hardship in long term international contracts, these two concepts first have to be considered on a general and theoretical basis.

4 *CHANGE OF ECONOMIC CIRCUMSTANCES BETWEEN FORCE MAJEURE & HARDSHIP*

First, it has to be pointed out that the notion of hardship in this paper is understood in accordance with the definition given in the UPICC in light of the scope to treat this concept on an international level by avoiding reference to existing domestic concepts which differ among one another and therefore do not match the international market's needs of uniform application of the contract law. Nonetheless, the majority of modern writers accept the doctrine of *rebus sic stantibus* and therefore, this doctrine has been further translated into the legislation under a number of related concepts. Just for the sake of offering a more comprehensive overview, on the national level, these concepts include the American commercial impracticability,[27] the English frustration of purpose,[28] the German Wegfall der Geschäftsgrundlage,[29] the French imprévision, [30] the Italian eccessiva onerositá sopravvenuta,[31] and the like.[32]

As this paper will try to show, economic unreasonableness or unaffordability of performance may also constitute an impediment to performance under the *force majeure* excuse as reflected in Art. 79 CISG. Indeed, the prevailing view accepts that

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27 Section 2-615 of the Uniform Commercial Code (**UCC**) excuses contractual performance when presupposed conditions upon which the contract is based have not been met. Also, s. 268 (2) of the Restatement (Second) of Contracts deals with the same contingency. Thus, excuse or partial relief is awarded if the occurrence of a certain contingency has made the performance impracticable.

28 The doctrine of "frustration of purpose" excuses performance when the circumstances have changed so much that the performance required by the contract is radically different from that which was initially undertaken by the parties. Recently, English judges have been reluctant to find that a particular contract has been frustrated. It is the general observation of the author that Courts have shown a willingness to imply in all contracts a condition to the effect that if the performance of a contract becomes physically or legally impossible, then the contract is dischargeable. Mere hardship is not sufficient under English law to discharge performance.

29 In German law, the theory of Wegfall der Geschäftsgrundlage (disappearance of the basis of the transaction) covers the effect of changed circumstances on the contract. When the circumstances have unforeseeably and substantially changed, the foundations of the transaction have been destroyed and the parties are no longer bound to their original contractual commitments, requesting the original performance of the contract would constitute bad faith (Art. 242 BGB requires that the contract be performed in good faith.). At present Wegfall der Geschäftsgrundlage is applied rather restrictively.

30 French contract law does not provide relief for changed circumstances which make contract performance more onerous but not impossible. The doctrine of imprévision is only applied by French administrative courts to contracts concluded with public entities. In commercial contracts, the agreed contract price is not affected by increased costs or currency depreciation. The doctrine of imprévision is developed by the Conseil d'Etat based only indirectly on Art. 1134 of the *French Civil Code*.

31 *Italian Civil Code*, Arts. 1467-1469. As the case law has evolved, the party who is unduly burdened because of changed circumstances may obtain a discharge of the contract, or the court can adapt the contract to changed circumstances if both parties want the contract to continue. The changed circumstances must be exceptional and the court must balance the interests of both parties.

32 *See* Liu, C., *Changed Contract Circumstances*, [2nd edition: Case annotated update (April 2005)], available at: <http://www.cisg.law.pace.edu/cisg/biblio/liu5.html#cl13>.

Art. 79 CISG applies not only to cases of physical or factual impossibility, but also to situation where performance has become excessively onerous (and not merely more onerous) for the obligor.[33]

In light of the fact that a growing opinion on interpreting Art. 79(1) CISG treats economic unaffordability as a ground for exemption thus covering most cases of changed economic circumstances, the relation between *force majeure* and hardship has to be further investigated. In addition, if a situation of economic unaffordability is to be assessed under Art. 79 CISG, the same threshold test (analysed below at para. VI) applies under the hardship exemption. Moreover, it must be noted that a fundamental distinction has to be drawn between situations where performance has become more onerous and those situations where performance has become *excessively* onerous. Indeed, Art. 79 seems to be applicable only in the latter case, and will then result in the obligor's discharge from its performance duty (consequences of *force majeure*) or in a court-ordered adaption or termination of the contract (consequences of the hardship exemption).[34] In other words, the risk of performance becoming more expensive or burdensome is generally to be borne by the obligor.

From a practical perspective, it would be unsatisfactory to treat cases of physical impossibility differently than cases of economic impossibility of unaffordability. Any factual impossibility has economic consequences and also a factual impediment may only excuse the obligor if it cannot reasonably be overcome, *i.e* at additional cost. Therefore, a case of economic unaffordability may also result from a factual impediment, which could be overcome, but only at an additional cost that is unreasonably excessive in comparison with the obligee's interest in receiving the goods. If an obligor is excused where a factual impediment can only be overcome at excessive cost, it could not be explained why the solution should be different where the performance becomes excessively burdensome as a result of a change of market conditions.

As aforementioned, the two major legal concepts dealing with the problem of changed circumstances are those of *force majeure* and hardship; they appear to be related to each other, particularly because they both cater to situations of changed circumstances. Nonetheless there are differences between these two concepts: "hardship is at stake where the performance of the disadvantaged party has become

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33 *See* Brunner, C., *supra* fn 1, at p. 213; and also CISG-AC Opinion No. 7 (2007), s. 3.1 and Comments Nos 26-39; P. Schlechtriem, *Uniform Sales Law – The Experience with Uniform Sales Law in the Federal Republic of Germany*, 1991/92, Juridisk Tidskrift; Jones, G.H. & Schlechtriem, P., "Breach of Contract (Deficiencies in a Party's Performance)" in *International Encyclopedia of Comparative Law*, Vol. VII (Contracts in General), Chapter 15, 1999, Tubingen, at. Para 217, p. 136; Bernardini, P., "Hardship e Force Majeure" in *Contratti commerciali internazionali e principi UNIDROIT* (ed), 1997, Bonell & Bonelli, Milan, at p. 200-207; Enderlein, F. & Maskow, D., *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods; Convention on the Limitation Period in the International Sale of Goods* (1992), Art. 79 CISG, par. 6.3, available at the Pace Database; Honnold, J.O., *Uniform Law for International Sales*, (3rd ed), 1999, The Hague, at 432.2.

34 *See* Brunner, C., *supra* fn 1, at p. 214.

much more burdensome, but not impossible, while force majeure means that the performance *[...]* the party concerned has become impossible, at least temporarily."[35]

Moreover, there seems to be a functional difference between the two concepts. Hardship constitutes a reason for a change in the contractual program of the parties, but the aim of the parties remains to implement the contract.[36] *Force majeure*, however, is situated in the context of non-performance, and deals with the suspension or termination of the contract.[37]

The concept of *force majeure*, providing for the discharge of one or both parties when a contract has become impossible to perform, "has evolved progressively in international trade practice by assuming many original and autonomous features distinct from similar legal concepts".[38] Even though the approach of different legal systems to situations of *force majeure* varies from country to country, certain general characteristics of *force majeure* can be determined. The roots of the classic concept lie in the Code Napoléon, from which the words *force majeure* (an irresistible compulsion or coercion) are taken.[39] Often a *force majeure* event is called an act of God, in other words an event happening independently of human volition, which human foresight and care could not reasonably anticipate or avoid.[40]

Force majeure occurs when the law recognises that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which the performance is called for would render it impossible.[41] A similar definition is contained in Art. 7.1.7 UPICC where, under the headline of 'force majeure', it is stated that a party's non-performance is excused if that party proves that the non-performance was due to an impediment beyond its control, and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome the impediment or its consequences.

On the other hand, the concept of hardship is usually discussed in contracts of international trade where these clauses are frequently introduced. The term 'hardship', however, has also been used in various legal systems.[42] With respect to those rules, courts had to interpret the term 'hardship' and determine its scope. Thus, it can be said that hardship may be regarded as the subjective effect of a detrimental

35 *See* Maskow, D., *supra* fn16, at p. 664.

36 Rimke, J., *supra* fn10.

37 Rimke, J., *supra* fn 10 at pp. 200-201.

38 Draetta, U., "Force Majeure Clauses in International Trade Practice" (1996) 5 *Int'l Bus. L. J.* 547.

39 See *James Stroud's Judicial Dictionary*, 1986, II 1008.

40 See *The Oxford Companion to Law*, 1980, at p. 14.

41 Puelinckx, A.H., "Frustration, Hardship, Force majeure, Imprévision, Wegfall der Geschäftsgrundlage, Unmöglichkeit, Changed Circumstances" (1986) J. *Int'l Arb.*, at p. 50.

42 For example in the *Australian National Security (Landlord and Tenant) Regulations* and the *Landlord and Tenant (Amendment) Act* 1948-1964.

nature upon the person concerned.[43] The circumstances in which hardship generally exists (as usually set out in hardship clauses) normally incorporate three elements. "First, the circumstances must have arisen beyond the control of either party; self-induced hardship is irrelevant. Second, they must be of fundamental character. Third, they must be entirely uncontemplated and unforeseeable".[44]

A clear descriptive definition of hardship is contained in Art. 6.2.2 UPICC which states that "[t]here is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished". The aforementioned article also provides essential characteristics of hardship situations such that could not reasonably have been taken into account at the time of contracting; they must be beyond the control of the disadvantaged party and also the latter must not have assumed the risk of such events. It has to be underlined again that the concept of hardship intends to solve problems of such fundamentally altered circumstances by adapting the contract to the new situation.

Having pointed out that hardship constitutes a reason for a change in the contractual program of the parties (even if the aim of the parties remains to implement the contract), and also that *force majeure* is situated in the context of non-performance (concept dealing with the suspension or termination of the contract), it is vital for the analysis conducted in the present article to read the two concepts in light of Art. 79 CISG. The latter, indeed, is the principal provision (in the CISG) governing the extent to which a party is exempt from liability for a failure to perform any of his obligations due to an impediment beyond his control.

Therefore, having analysed both concepts and compared them to the issue at stake, the notion of changed economic circumstances appears to have the legal and economic features of a hardship situation.

5 *THE REQUIRED CONCEPT OF FUNDAMENTAL ALTERATION OF THE EQUILIBRIUM OF THE CONTRACT*

The question whether an alteration of the equilibrium of the contract is to be considered as 'fundamental' is of vital importance.

All relevant circumstances must be taken into account when drawing the borderline between situations where, due to supervening events, performance of a contract becomes, directly or indirectly, merely more onerous for one of the parties, and situations where it becomes so *excessively* onerous that the relevant party cannot reasonably be expected to perform in accordance with the terms of the contract.[45] The use of the term directly implies that the performance of the contract becomes more or

43 Rimke, J., *supra* fn10, at p. 199.

44 Schmitthoff, C. M., "Hardship and Intervener Clauses"(1980) *J. Bus. L.* at pp. 82-85.

45 Brunner, C., *supra* fn 1, at p.426.

excessively onerous because of an increase in cost of performance, while indirectly stands for a decrease in value of the performance received.

The significance of the decision to select the conditions under which a party's obligations will be excused goes to the core of the theory of contracts. As analysed in paragraph III, there is an inherent tension between the concept of *pacta sunt servanda* and the possibility that a party could fail to perform a promised obligation and yet escape liability for breach. Thus, to the extent that contracts exist to provide predictability in business transactions and to protect the expectation interests of contracting parties, it must be noted that courts likely will be reluctant to excuse a non-performing party from its obligations under its contract.[46]

Nevertheless, there are instances where holding a party to its promise causes manifest unfairness.

Furthermore, Peter Schlectriem has warned that it is "imperative [...] to treat radically changed circumstances as 'impediments' under Article 79 CISG in exceptional cases in order to avoid the danger that courts will find a gap in the Convention and invoke domestic laws with their widely divergent solutions".[47]

As noted above, Art. 6.2.2 UPICC does not state when the equilibrium of the contract has been fundamentally altered. The Official Comment on the UPICC (1994 edition) includes an explicit statement as to what degree is required in order to constitute a hardship situation: "whether an alteration is 'fundamental' in a given case will of course depend upon the circumstances. If, however, the performances are capable of precise measurements in monetary terms, an alteration amounting to 50% or more of the cost or the value of the performance is likely to amount to a 'fundamental' alteration".[48] As it will be shown in the following paragraph, this threshold is no longer considered acceptable.

Whether equilibrium has been so greatly disturbed that a remedy must be granted, is left to the appreciation of the parties and finally to the court or to the arbitrator. Arbitrators have often been rather reluctant to intervene in the contract on the basis of hardship where the parties did not provide for this possibility, for instance by including a hardship clause.[49] For example, in ICC 6281, the arbitrators refused to intervene because: "otherwise, any business transaction would be exposed to uncertainty, or even be rendered impossible altogether, whenever the mutual covenants are not performed at the time at which the contract is concluded".[50]

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46 Weidzmann, T., "Validity and excuse in the U.N. Sales Convention," (1997) 16 *J.L. & Com.* 265.

47 Schlechtriem, P., *Uniform Sales Law, The UN-Convention on Contracts for the International Sale of Goods, Manzsche Verlags und Universitätsbuchhandlung*, 1986, Wien, at p. 192.

48 Comment No. 2 on Art. 6.2.2 UPICC (1994 edition).

49 *See* van Houtte, H., *supra* fn 13 at p 105.

50 *See* ICC Award No. 6281 (1989), Yb. Comm. Arb., 1990, at pp. 96ff.

In this direction, the adoption and use of a common threshold test, that is, the determination of a percentage of the cost or the value of the performance likely to amount to a fundamental alteration of equilibrium of the contract, generally fulfils a need in practice. However, any threshold test can only serve as a general starting point for the legal analysis and cannot be used without taking into great consideration the specific circumstances of the case.

6 THRESHOLD TEST OF THE HARDSHIP EXEMPTION

The starting point for the evaluation of the establishment of a threshold test has to be the contract itself. Primarily, it is up to the parties to define their respective spheres of risk in the contract. One party may have expressly or impliedly assumed the risk for a fundamental change of circumstances or, on the contrary, certain risks may have been expressly or impliedly excluded. This determination can be done by simple contract interpretation.[51]

As aforementioned, the hardship exemption is based not only on the central investigation of whether the disadvantaged party assumed the risk, but also on how much risk the disadvantaged party assumed. Indeed, in hardship situations, it is typically a question of degree as to whether performance of the contract has become excessively onerous, and whether it is still reasonable to have the obligor carry the risk of changed circumstances.[52]

In order to compare similar factual situations with each other and to ensure that they are assessed against the same standard, it is important to develop such a general threshold test. Moreover, the general principle of predictability of law and the postulate of plausibility of decisions support the need for such a general starting point.[53]

As mentioned above, the Official Comment on the UPICC introduced a 50% threshold test (alteration amounting to 50% or more of the cost or the value of the performance); nonetheless, jurists, practitioners, judges and also arbitrators have continuously suggested that the alteration should be at least 100%.[54]

From a general contract principles' perspective, since both common law systems and major civil law systems recognise an exception due to frustration of purpose, an alteration between a 80%–100% decrease in the value received, or a corresponding increase in the cost of performance of the same order of magnitude or of about 100–

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51 Schwenzer, I., "Force Majeure and Hardship in International Sales Contracts" (April 2009) 39 *Victoria University of Wellington Law Review* at pp. 709-725.

52 Brunner, C., *supra* fn 1, at pp. 392-393.

53 *Ibid.*, at p. 427.

54 *See* Enderlein, F. & Maskow, D., *International Sales Law: United Nation Convention on Contracts for the International Sale of Goods; Convention on the Limitation Period in the International Sale of Goods*, art. 79 CISG par. 6.3 (1992), available at Pace Law School Database on CISG; *see also* Berger, K.P., *Private Dispute Resolution in International Business*, Vol. II, 2006, The Hague, at para. 24-66.

125% may be seen as a general point of reference for the hardship test.[55] This amount of alteration is in line with the percentage proposed by the case law and legal commentators under civil and common law systems, as well as by Art. 79 CISG referred to above.

It is necessary to underline again that this threshold test is applicable only to standard situations where the relevant risk has not completely or partially been assumed by one of the parties. Indeed, in a 'non standard' situation, the aggrieved party may not avail itself of the hardship exemption unless the alteration of the equilibrium of the contract is, in proportion to the extent of the risk assumption, greater than approximately 100%.[56] Conversely, a smaller alteration of the equilibrium of the contract can be sufficient in situations where the economic existence of the obligor would be seriously and effectively endangered if it were held to be bound by the unmodified terms of the contract or in specifically determined assumptions by the parties.

In case of long-term contracts (in particular construction contracts), it is more likely that during the course of its performance the basis on which the original bargain was struck may change more dramatically than in the case of 'short-term' contract. However, in principle, the same standards should apply to both short-term contracts and long-term contracts and, indeed, there is no particular rule which states a lower threshold test of the hardship exemption for long-term contracts.

Moreover, as the performance of long-term contracts will extend over many years, the parties may be deemed to have taken the risk of foreseeable market changes into account at the time of contracting, and thus to have allocated the relevant risk accordingly.[57] The essentially speculative nature of a long-term contract is regarded in many states all over the world and also under general contract principles as an argument against discharge by reason of changing market conditions. It is also to be emphasised that the failure to incorporate an appropriate adaption clause into the contract does not exclude the application of the hardship exemption. Whether and to what extent the standard hardship threshold test is supplanted or increased in case of long-term contracts due to explicit or implicit risk assumption may only be assessed on the basis of the terms of the contract and all surrounding circumstances. If a

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55 Both in civil law and common law, cases involving 'frustration of purpose' have been traditionally treated as a separate category of cases that are distinguished from the concept of 'impossibility of performance'. Under general contract principles, the doctrine of frustration of purpose is a particular category of cases of the hardship exemption. In cases of alleged frustration of purpose, the recipient's case is that the supplier's performance (which is still possible) is no longer of any use to it for the purpose for which both parties had intended it to be used. Therefore, frustration of purpose is, in principle, distinguished from 'impracticability' (economic unaffordability) too, on the ground that the normal position in the latter situation is that the supplier argues that the cost of the performance has increased, whereas in cases of alleged frustration of purpose it is normally the recipient which argues that the value of the performance received has substantially decreased. Those considerations are based on my observation of several cases in English, American and Italian Courts.

56 *See* Brunner, C., *supra* fn 1, at p. 432.

57 *Ibid.* at p. 439.

particular risk is specifically addressed in the contract, the relevant risk allocation is usually exhaustive and leaves no room for the application of the hardship concept.

In the absence of an explicit risk assumption, it has to be determined whether the occurrence of the hardship event was reasonably foreseeable. In international contracts, particularly in long-term investment agreements, the risk of the occurrence of contingencies, such as inflation, currency fluctuation and economic downturn, is usually explicitly or implicitly assumed by the relevant party.[58] Therefore, a party must give a detailed justification of the impact of the unforeseeable contingency upon the contract in order to have a concrete possibility to prevail on a hardship claim.

7 *TREATMENT OF HARDSHIP UNDER INTERNATIONAL CONTRACT PRINCIPLES*

The growth in international trade has led to the re-emergence of the need for the harmonisation of the services that facilitate overseas trade: global monetary mechanisms, cross-border transport possibilities, and universal rules and standards which allow traders the world over to conduct business on the same terms.[59] Therefore, the legal community has tried to facilitate overseas trade through efforts to harmonise national laws by legislative or non-legislative means; thereby reducing the uncertainties and potential costs associated with transacting business under unfamiliar laws.

Among such efforts, the highest contribution belongs to the CISG. On the other hand, the need of general principles in international contract law, usage and custom of international trade and *lex mercatoria* has led to certain other unification actions in addition to the CISG. Since the CISG came into force in 1988, there have been other efforts to develop overall unifying principles covering the field of contract law. The UPICC and the PECL, introduced respectively in 1994 and 1998, represent the core of such other efforts. Since their introduction, the international trading community has generally accepted these rules and thereby they achieved a position to be regarded as *lex mercatoria*.[60] It is, nonetheless, to be emphasised that CISG is the only one among the three instruments, *i.e.* CISG, UPICC and PECL, with mandatory application to the signatory States.

These are internationally drafted instruments governing contracts which combine elements from both civil law and common law systems. The CISG harmonised interests and ideas of different legal systems and of countries on different levels of economic development are understood as a modern uniform substitute for the wide array of foreign legal systems. Thus, it is a text equally suited for implementation in

58 Brunner, C., *supra* fn 1, at p. 441.

59 Williams, A.E., *Forecasting the Potential Impact of the Vienna Sales Convention on International Sales Law in the United Kingdom? Pace Review of the Convention on Contracts for the International Sale of Goods* (CISG), 2000-2001, Kluwer Law International, at pp. 9-57.

60 Koskinen, J., "CISG, Specific Performance and Finnish Law?" (1999), Publication of the Faculty of Law of the University of Turku, Private law publication series B:47.

civil law and common law countries, for developed economies as well as for those that are developing. The UPICC and the PECL in turn represent the latest developments in the field of contract law and combine civil law and the common law with international contract practices.

As already mentioned, the rules dealing with situations of changed or supervening contractual circumstances are oriented on the two basic concepts of hardship and *force majeure*, constituting exceptions to the cardinal canon of *pacta sunt servanda*.

As analysed in para. IV of Art. 79 CISG seems to be applicable to situations where performance has become excessively onerous (not to situations where performance has become merely more onerous) in light of both an interpretation of Article 79 CISG, together with its UPICC and PECL's "sister provisions" and practical considerations. However, it would be unsatisfactory to treat cases of physical impossibility differently than cases of economic impossibility of unaffordability.

Article 79 CISG avoids any mention of hardship and force majeure and uses elastic words like impediment and exemption. Therefore, assuming that the CISG applies to a contract,[61] and also assuming that a hypothetical event falls within a factually justified case of hardship, the most relevant question to explore is whether a case of economic hardship should be settled by the CISG, either by reading the word 'impediment' in Art. 79 to include economic hardship (as the present paper sustains) or by concluding that there is a gap within the CISG to be filled by some underlying general principles via the gap-filling technique promoted in Art. 7(2) CISG. If the CISG applies, then it naturally preempts other potentially applicable domestic rules dealing with hardship.[62]

Thus, according to Art.7(1) CISG, "[i]n the interpretation of this Convention regard is to be had to its international character and to the need to promote uniformity in its application *[...]*". Since the UPICC are also of international character, it seems permissible to make use of them as a means of interpreting the CISG, provided that the relevant provisions of the UPICC serve the same purpose as their corresponding provisions in the CISG and that they are in conformity with the rules of interpretation

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61 For additional details on the basic rules of applicability of the Convention, *see* Ferrari, F., *Editorial analysis of CISG Article 1*, available at: <http://www.cisg.law.pace.edu/cisg/text/cross/cross-1.html>; *see also* Ferrari, F., *The Sphere of Application of the Vienna Sales Convention* 11, 1995, Cambridge; Kritzer, A.H., *Guide to Practical Applications of the United Nations Convention on Contracts for the International Sale of Goods*, 1989, Deventer, Boston. The kind of contract and where the parties have their relevant places of business determine the applicability of the CISG. The CISG can apply to contracts between domestic corporations, if their relevant places of business are in different Contracting States. *See Asante Technologies, Inc. v. PMC-Sierra, Inc.*, 164 F.Supp.2d 1142 (N.D. Ca., 2001), which concerns a contract between two Delaware corporations.

62 Garro, A.M., "Exemption of liability for damages: Comparison between provisions of the CISG regarding exemption of liability for damages (Art. 79) and the counterpart provisions of the UNIDROIT Principles (Art. 7.1.7)" in *An International Approach to the Interpretation of the United Nation Convention on Contract for the International Sale of Goods* (1980) as Uniform Sales Law, Felemegas, J. (ed.), 2007, Cambridge.

under the CISG.[63] These rules, which can also be regarded as general principles in terms of Art.7(2) CISG, require first and foremost taking account of the plain text of a provision.[64]

If the wording is vague (as with Art.79 CISG which does not mention neither force majeure events nor hardship situations), the literal interpretation must be supported by other methods of interpretation, namely looking at the provision's legislative history, its context within the CISG's remedial system, its objectives and underlying policies.[65]

Moreover, the preamble to the UPICC states that "[the Principles] may be used to interpret or supplement international uniform law instruments" and it is also to be emphasised that many of the persons who worked on the UPICC participated in the development of the CISG. "Naturally, to the extent that the UNIDROIT Principles address issues also covered by the CISG, they follow the solutions found in that Convention, with such adaptations as were considered appropriate [...]".[66]

In a similar vein, one of the principal architects of the Principles has stated: "To the extent that the two instruments address the same issues, the rules laid down in the UNIDROIT Principles are normally taken either literally or at least in substance from the corresponding provisions of CISG; cases where the former depart from the latter are exceptional".[67]

Similar interaction between provisions that can be useful to show the deep relation existing between the CISG and the UPICC is found in the United States. Indeed,

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63 Felemegas, J., "The United Nations Convention on Contracts for the International Sale of Goods: Article 7 and Uniform Interpretation" in *Pace Review of the Convention on Contracts for the International Sale of Goods* (CISG), 2000-2001, Kluwer Law International, at pp. 115-265; Garro, A., "The Gap Filling Role of the UNIDROIT Principles in International Sales Law: Some Comments on the Interplay between the Principles and the CISG" (1995) 69 *Tul.L.Rev.* 1149, at p. 1157 (stating that "the UNIDROIT principles may be resorted to in order to determine whether or not there has been a fundamental breach of contract"); Perillo, J.M., "UNIDROIT Principles of International Commercial Contracts: The Black Letter Text and a Review" (1994) 63 *Fordham L. Rev.* 281, at pp. 308-309.

64 Koch, R., "The Concept of Fundamental Breach of Contract under the United Nations Convention on Contracts for the International Sale of Goods (CISG)" in *Pace Review of the Convention on Contracts for the International Sale of Goods* (CISG) 1998, 1999, Kluwer Law International, at p. 194, also available at: <http://cisgw3.law.pace.edu/cisg/biblio/koch.html>; Enderlein, F., "Uniform Law and its Application by Judges and Arbitrators" in UNIDROIT (ed), *International Uniform Law Practice*, 1988, Oceana, New York, at pp. 329-353; van der Velden, F.J., "The Law of international Sales: The Hague Conventions 1964 and the UNCITRAL Uniform Sales Code 1980 -- Some Main Items Compared" in Voskuil & Wade. (eds.), *Hague-Zagreb Essays 4*, 1983, Asser Instituut/Martinus Nijhoff, The Hague, at p. 24; Diedrich, F., "Maintaining Uniformity in International Uniform Law via Autonomous Interpretation: Software Contracts and the CISG" (1996) 8 *Pace Int'l L. Rev.* 303, at p. 328, also available at: <http://cisgw3.law.pace.edu/cisg/biblio/Diedrich.html>.

65 *See* Honnold, J., *supra* fn 33 at s. 103.2; Koch, R. *supra* fn 64, at pp. 192ff.

66 Introduction to the UPICC; Viscasillas, P.P., "UNIDROIT Principles of International Commercial Contracts: Sphere of Application and General Provisions" (1996) 13 *Arizona Journal of International and Comparative Law* at p. 385.

67 Bonell, M.J., The UNIDROIT Principles of International Contracts and CISG: Alternative or Complementary Instrument? (1996) *Uniform Law Review*, at pp. 26-39.

when a tribunal is ruling on sales provisions of the UCC references to the Restatement (Second) of Contracts are frequently encountered. Its examples and explanations of the meaning of terms and concepts are useful.[68] In UCC proceedings, courts and arbitrators refer to the Restatement of Contracts as it helps them reason through the applicable law.[69] Indeed, the American Restatement of Contracts is comparable with the UPICC and the UCC is comparable with the CISG.

In other words, since the UPICC is an international restatement, where its articles are supportive of the intent of the CISG, it can be logical to seek to apply the UPICC as guideline or gap filler when interpreting provisions of the CISG.[70] In such cases, the two instruments can supplement each other.

As far as the PECL is concerned, it is to be said that it covers similar areas of law to the UPICC, but its geographical sphere of application is confined to the EU. The material scope of the application of the PECL is, however, wider than that of the UPICC, as it is intended to apply to all contracts including domestic transactions and those involving consumers and merchants. So while the PECL is of a narrower geographic focus than the UPICC, it covers a wider area of law. Despite this, the substantial scope of application of the two Principles (i.e. the UPICC and the PECL) is identical in that they both aspire to be general principles of contract law.

In so far as the three instruments seem to have their own *raison d'être*, they not only do not compete with each other but may actually fulfill very important functions side by side. Particularly, so as to preclude an easy resort to the domestic law indicated by the conflict of law rule of the forum, the UPICC and the PECL serve a gap-filling role for the interpretation of CISG contracts; they endorse and promote many of the principles outlined in the CISG. Although, in this instance, the articles are not drafted in an identical or substantially similar manner, it is nonetheless possible to identify some supports and the two Principles can be used to: (1) interpret the CISG; (2) answer unresolved questions that fall within the scope of the CISG; or (3) resolve issues that are not addressed in the CISG.

According to this interpretation, Article 79 CISG can be supplemented by the comparable provisions of UPICC and PECL.

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68 In a similar vein, *see Austrian Arbitral Proceeding SCH-4318* and *Arbitral Proceeding SCH-4366* (both dated 15 June 1994); see also ICC Award No. 8128 of 1995, France Court of Appeal of Grenoble 23 October 1996; ICC Award No. 11638 of 1992, ICC Award No. 12097 of 1993, ICC Award No. 12460 of 1994, China CIETAC Arbitral Award of September 2004, Serbia Foreign Trade Court of Arbitration, Serbian Chamber of Commerce 23 January 2008, as examples of cases in which tribunals have referred to the UPICC as it helped them reason through the CISG. One can anticipate many such references to the UPICC in CISG proceedings.

69 Kritzer, A.H., *General observations on use of the UNIDROIT Principles to help interpret the CISG,* available at: <http://www.cisg.law.pace.edu/cisg/text/matchup/general-observations.html#un6>.

70 Bonell, M.J., *An International Restatement of International Commercial Contracts*, 2nd ed., 1997, Transnational Publications, New York, at p. 6.

The provisions of the CISG, UPICC and PECL which deal with hardship may be found in substantially similar terms in Art. 79 of CISG, Art. 6.2.2 and 7.1.7 of the UPICC, as well as Art. 6:111 and Art. 8:108 of the PECL.